United States Court of Appeals

for the Second Circuit

APPELLANT'S SUPPLEMENTAL BRIEF

Original

75-7203

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United States Court of Appeals
FOR THE SECOND CIRCUIT

ROBERT ABRAHAMSON and
MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

—v.—

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

UNITED STATES COURT OF APPEALS
FILED
FEB 2 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

SUPPLEMENTAL BRIEF FOR APPELLANTS

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Plaintiffs-Appellants,	:	
-against-	:	Dkt. No. 75-7203
MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY,	:	
Defendants-Appellees.	:	

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SUPPLEMENTAL BRIEF FOR APPELLANTS

Preliminary Statement

This brief is submitted on behalf of plaintiffs-appellants Robert and Marjorie Abrahamson ("appellants" or the "Abrahamsons") pursuant to the request of this Court, in its interim opinion of November 21, 1975, that the parties file supplemental briefs on the issues raised herein under the Investment Advisers Act of 1940. The Court has asked that the issues to be briefed include the issue of whether there exists a private right of action under the Advisers Act. The Court has also asked that the supplemental briefs

discuss the legislative history of the Advisers Act and the differences in phraseology between Section 214 of the Advisers Act and the corresponding jurisdictional provisions of the other federal securities laws.

The Abrahamsons have alleged violations of Section 206 of the Investment Advisers Act, 15 U.S.C. §80b-6, and of Rule 10b-5 under the Securities Exchange Act of 1934 arising out of their investment in limited partnership interests in an investment partnership. The principal impropriety alleged was that defendants had concealed the fact that the partnership had made very substantial investments in unregistered securities.

The District Court (Hon. Robert L. Carter, U.S D.J.), deciding motions by both sides for summary judgment, dismissed the complaint on the ground that the Abrahamsons suffered no damages. 392 F. Supp. 740 (S.D.N.Y. 1975).

In connection with their claims under the Advisers Act, the Abrahamsons urge that they were entitled to full disclosure concerning the nature of their investment and any changes therein throughout the period of the relationship, and certainly at all times when communications were made to them on which they could be expected to act or rely.

One such time, they urge, was when the annual financial statements of the partnership for fiscal 1968 were sent to them. Those statements showed their combined capital accounts to have a value of well over $1,000,000, but did not disclose that approximately 72% of the partnership's investment in securities was in unregistered securities. At about the same time, they were also asked to execute a new partnership agreement, containing substantial changes in the relationship, including changes which would benefit the general partner-defendants.

Appellants ultimately learned the truth, and withdrew from the partnership at the earliest possible time thereafter. The amounts they received on withdrawal, added to interim withdrawals they had made over the years, totalled slightly more than amounts they had initially invested. On this basis, the District Court ruled that no damages were recoverable under Rule 10b-5. Concluding that damages under the Advisers Act are subject to no different rule, the Court also dismissed the Advisers Act claim.

The amounts recovered by appellants were far less than the value of their capital accounts at the time of defendants' breach of duty, however.

Appellants urge below that a private right of action under the Advisers Act exists, that defendants are subject to the antifraud provisions of that Act, and that damages are recoverable thereunder. Appellants urge that the rule of damages which should be applied in actions under the Advisers Act must be derived from an examination of the nature and purposes of that Act, from the nature of the fiduciary duties imposed on advisers under that Act, and from the obvious consequences of breaches of those duties. The rule applied by the District Court may well be suited to situations involving the purchase or sale of a security, where a duty of disclosure is owed to a purchaser at the time of his purchase and to a seller at the time of his sale. Such a rule makes no sense in the context of a fiduciary relationship, such as the adviser-client relationship, wherein a duty of disclosure is owed throughout the duration of the relationship; wherein a duty of disclosure certainly attaches at any time advice is given or withheld or communications are sent to clients on which they may rely; and where the adviser is being paid to give advice, not only on when to purchase or sell, but when to hold an investment.

<u>POINT I</u>

APPELLANTS, AS PERSONS INJURED BY THEIR INVESTMENT ADVISERS' BREACH OF THE DUTY TO DISCLOSE, MAY ASSERT A PRIVATE RIGHT OF ACTION FOR DAMAGES UNDER SECTION 206 OF THE INVESTMENT ADVISERS ACT.

A. It is settled that a breach of the duties imposed under a penal statute gives rise to an implied private right of action on the part of those persons the statute was designed to protect, unless the legislature has clearly indicated a contrary intent.

As this Court has noted in its interim opinion of November 21, 1975, no federal appellate court has yet ruled on the question whether a private right of action exists under the Advisers Act. Implied private rights of action have been found, however, under all of the other major federal securities laws.

This has been no more than an application of the settled principle that persons injured by another's violation of a criminal statute will be given a private remedy, even though the statute may be silent on the subject. This doctrine was established in the law of England at least as early as the decision in <u>Couch</u> v. <u>Steel</u>, 3 E.&B. 402, 411, 118 Eng. Reprint 1193, 1196 (Q.B. 1854), and may have roots several hundred years older. See 2 Loss, <u>Securities Regulation</u>

pp. 934 et seq. (2d ed. 1961, Supp. 1969), for a discussion of the history of the doctrine of implied private rights of action.

In the early case of Texas & Pacific R. Co. v. Rigsby, 241 U.S. 33 (1916), the Supreme Court concluded that there was an implied private right of action for damages under the Federal Safety Appliance acts. The Court said (p. 39),

> "None of the acts, indeed, contains express language conferring a right of action for the death or injury of an employee; but the safety of employees and travelers is their principal object, and the right of private action by an injured employee, even without the Employers' Liability Act, has never been doubted . . . . A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied, according to a doctrine of the common law expressed in 1 Com. Dig., title, 'Action upon Statute' (F), in these words: 'So, in every case, where a statute enacts, or prohibits a thing for the benefit of a person, he shall have a remedy upon the same statute for the thing enacted for his advantage, or for the recompense of a wrong done to him contrary to the said law.'"

See also the recent decision in Cort v. Ash, 422 U.S. 66 (1975). There the Court found no private right of action by stockholders under 18 U.S.C. §610

(prohibiting corporate political contributions), because any legislative intent to protect stockholders "was at best a subsidiary purpose of §610" (p. 80), the primary purpose being to cleanse the election process. The Court listed the factors, however, which are relevant in determining whether a statute supports a private remedy (p. 78):

> "First, is the plaintiff 'one of the class for whose especial benefit the statute was enacted,' .... Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? .... Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? .... And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

Compare Rauch v. United States Instruments, Inc., _____ F.Supp. ______, 44 L.W. 2149 (E.D. Pa., September 11, 1975), wherein the Court, applying the principles of Cort v. Ash, found an implied private right of action under the Federal Aviation Act.

The implication of private rights of action is based upon the concept of tort law that the violator of a statute is

liable to one for whose benefit the statute was enacted, where the statute was designed to protect the "interest invaded" against the harm which has resulted. See Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946). See also Restatement, Torts 2d, §286, which states,

> "The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or an administrative regulation whose purpose is found to be exclusively or in part
>
> (a) to protect a class of persons which includes the one whose interest is invaded, and
>
> (b) to protect the particular interest which is invaded, and
>
> (c) to protect that interest against the kind of harm which has resulted, and
>
> (d) to protect that interest against the particular hazard from which the harm results."*

The courts have found implied private rights of action, not only under the securities laws, as is discussed further below, but also under various other federal statutes which do not expressly provide for private remedies. See, e.g., Tunstall v. Brotherhood of Locomotive Firemen & Enginemen, 323 U.S. 210 (1944) (the Railway Labor Act); Reitmeister v. Reitmeister, 162 F.2d 691 (2d Cir. 1947) (the Communications Act

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* Although the doctrine arose in tort cases, Professor Loss has pointed out that subsequently "the doctrine came to be applied to violations of criminal statutes without a negligence flavor." 2 Loss, supra at 935.

of 1934); Neiswonger v. Goodyear Tire and Rubber Co., 35 F.2d 761 (N.D. Ohio 1929) (Air Commerce Act of 1926).

Because they were enacted primarily for the protection of investors, the securities laws have been the subjects of many decisions finding implied private rights of action. For example, this Court said, finding a private right of action under the Public Utility Holding Company Act of 1935 in Goldstein v. Groesbeck, 142 F.2d 422, 427, (2d Cir. 1944), cert. denied, 323 U.S. 737 (1944),

> ". . . [W]e think a denial of a private right of action to those for whose ultimate protection the legislation is intended leaves legislation highly publicized as in the public interest in fact sadly wanting, and even delusive, to that end."

See also J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (proxy rules); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967) (the Securities Act of 1933); Kardon v. National Gypsum Co., supra, 69 F. Supp. 512 (E.D. Pa. 1946) (the Securities Exchange Act of 1934); Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961), aff'd en banc, 294 F.2d 415 (2d Cir. 1961) (the Investment Company Act of 1940). And see Baird v. Franklin, 141 F.2d 238 (2d Cir. 1944), cert. denied, 323 U.S. 737 (1944), wherein Judge Clark, dissenting*, stated (pp. 244-5),

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* The majority did not disagree with Judge Clark on this point. It assumed the action was properly brought but disagreed with Judge Clark on the merits.

"If the investing public is to be completely and effectively protected, Section 6(b) [of the Securities Exchange Act] must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed..."

In J.I. Case Co. v. Borak, supra, 377 U.S. 426 (1964), the Supreme Court, referring to Section 14(a) of the 1934 Act, and the proxy rules, stated (p. 432),

". . . While this language makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."

* * *

". . . Private enforcement of the proxy rules provides a necessary supplement to Commission action. . . ."

Because the doctrine of implied private rights of action is so deeply rooted in our law, there is a presumption in favor of its application, except where a contrary legislative intent appears very plainly. As the Court said in Kardon v. National Gypsum Co., supra, 69 F. Supp. 512, 514, in which a private right of action under Rule 10b-5 was found,

"Of course, the legislature may withhold from parties injured the right to recover damages arising by reason of violation of a statute but the right is so fundamental and so deeply ingrained in the law that where it is not expressly denied <u>the intention to withhold it should appear very clearly and plainly</u>." (Emphasis added.)

* * *

> ". . . In other words, in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies."

In view of the foregoing, the questions to be decided are (1) whether the appellants here were intended to be protected under the Advisers Act from the harm here alleged, in light of the language and purposes of that Act; and (2) whether it was the plain intention of the Congress to withhold a private remedy.

B. <u>In light of the purposes and history of the Advisers Act, the implication of a private right of action is seen to be entirely consistent with the Congressional intent.</u>

Pursuant to the mandate of Section 30 of the Public Utility Holding Company Act of 1935, 15 U.S.C. §79z-4, the Securities and Exchange Commission made a study in the 1930's of the "functions and activities of investment trusts and investment companies . . . " As part of this study, the Commission also examined the practices of investment counseling and investment advisory services.

The Commission submitted a report of its study

to the Congress in August of 1939. See Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, On Investment Counseling, Investment Management, Investment Supervisory, and Investment Advisory Services, H. R. Doc. No. 477, 76th Cong., 2d Sess. (the "SEC Report"). The SEC Report recited a number of abuses which had been found to exist in the industry, and recommended legislation. The SEC Report, and the hearings which followed, resulted in the passage of the Advisers Act.

As the House Committee on Interstate and Foreign Commerce put it, the essential purpose of the Advisers Act is to

> ". . . protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."

H. R. Rep. No. 2639, 76th Cong. 3d Sess., p. 28.

That the Advisers Act was intended for the protection of investors is also made plain elsewhere in the legislative history. For example, S. Rep. No. 1775, 76th Cong., 3d Sess. (1940), states (p. 21),

> "The nature of the functions of investment advisers, their potential influence on

security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this Committee [Committee on Banking and Currency] that protection of investors requires the regulation of investment advisers on a national scale."

See also the Senate Committee Report on S. 3773, which contained the 1960 Amendments to the Advisers Act, S. Rep. No. 1760, 86th Cong., 2d Sess., 1960 U.S. Code Cong. & Admin. News, p. 3503, wherein it is said,

> "The general objective of the Investment Advisers Act of 1940 is to protect the public and investors against malpractice of persons paid for advising others about securities."

The Congress not only intended the Advisers Act to protect investors, but also intended that the Act constitute a recognition of the fiduciary nature of the adviser relationship. Moreover, the Congress intended that the Act be interpreted in accordance with this recognition. The original bill which was to become, with some changes, the Advisers Act, stated in its declaration of policy,

> "Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . it is hereby declared that the national public interest and the interest of investors are adversely affected -- . . . (4) when the business of investment advisers is so

conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients. It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and so far as is presently practicable to eliminate the abuses enumerated in this section."

S. 3580, 76th Cong., 3d Sess., §202.

The Act as ultimately adopted did not contain this language, but the Supreme Court has held that the elimination of a section attributing specific abuses to the investment adviser profession was only "to avoid condemning an entire profession . . . for the acts of a few." SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191 (1963).

The fiduciary elements of the adviser-client relationship were also stressed in testimony given during Congressional hearings on the legislation. For example, investment advisers who testified emphasized their relationship of "trust and confidence" with their clients. See Hearings on S. 3580 before Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., p. 719 (quoted in SEC v. Capital Gains Research Bureau, supra, 375 U.S. 180, 190).

Certain parts of the history of the Advisers Act are traced in detail in SEC v. Capital Gains Research Bureau, supra. In that case, the Supreme Court made the following observations concerning the purposes of the Advisers Act:

> "The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1940. A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." (p. 186; emphasis added.)
>
> * * *
>
> "The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' . . . " (p. 191)
>
> * * *
>
> "Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." (p. 194)

* * *

"The Investment Advisers Act of 1940 was 'directed not only at dishonor, but also at conduct that tempts dishonor.' . . . . Failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920's and 1930's amply reveals, the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive." (p. 200)

* * *

"Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes." (p. 195; emphasis added.)

The purposes of the Act, then, are to protect investors, to promote full disclosure by advisers to their clients, to achieve a high standard of business ethics among advisers, and to prevent breaches of the fiduciary duties inherent in the adviser-client relationship. Do these purposes indicate that a private right of action under the Act should be held to be maintainable? We think they plainly do. In this connection, it is worthwhile to quote again from the decision in J. I. Case Co. v. Borak, 377 U.S. 426 (1964), wherein the Supreme Court said (p. 432),

"While this language makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."

The Court also said in J. I. Case Co. v. Borak that

"... it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose" (p. 433).

C. A textual analysis of the Advisers Act demonstrates that the structure and language of the Act support the implication of a private right of action.

The Advisers Act claims of appellants herein are brought under Section 206 of the Act, 15 U.S.C. §80b-6, which reads as follows:

"It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly --

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as

broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Obviously, Section 206 itself says nothing about private rights of action. It does, however, make "unlawful" certain kinds of conduct. This Court has held, in an action under Section 10(b) of the Securities Exchange Act of 1934, that the use of the word "unlawful" supports the implication of a private remedy. In <u>Fischman</u> v. <u>Raytheon Mfg. Co.</u>, 188 F.2d 783 (2d Cir. 1951), the Court said (p. 787),

"Section 10(b), to be sure, does not explicitly authorize a civil remedy. Since, however, it does make 'unlawful' the conduct it describes, it creates such a remedy."

Further evidence that private remedies are not

inconsistent with the purpose of the Act is found in other sections. Section 206A, 15 U.S.C. §80b-6a, for example, permits the Securities and Exchange Commission to exempt persons or transactions from any provision of the Act, but only if and to the extent that such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act.

Perhaps even more important is the language of Section 215 of the Act, 15 U.S.C. §80b-15, which invalidates contracts involving violation of the Act and agreements binding persons to waive compliance with any of its provisions. Section 215 reads as follows:

> "(a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this subchapter or with any rule, regulation, or order thereunder shall be void.
>
> (b) Every contract made in violation of any provision of this subchapter and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder

with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision."

Section 215, by itself, mandates the conclusion that private rights of action may be maintained under the Advisers Act. Without a private right of action, a person otherwise entitled under Section 215 to a declaration that a contract is void would find the courthouse doors closed to him, and would have no means of enforcing the rights given to him under Section 215.

The 1934 Act contains a similar provision respecting the validity of contracts. Section 29 of the 1934 Act, 15 U.S.C. §78cc, provides, in pertinent part, as follows:

> "(a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.
>
> (b) Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security or an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance

> of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation. . . ."

The existence of Section 29 has been one of the strongest factors leading the courts to hold that a private right of action may be maintained under Section 10(b) and Rule 10b-5. See, for example, Kardon v. National Gypsum Co., supra, 69 F.Supp. 512 (E.D. Pa. 1946), wherein the Court, referring to Section 29, said (p. 514),

> "It seems to me that a statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it. The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences."

The importance of Section 29 in the decisions implying private remedies under Section 10(b) was recalled by the Supreme Court just last year, in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). There the Court pointed out (p. 735),

> "One of the justifications advanced for implication of a cause of action under §10(b) lies in §29(b) of the 1934 Act, 15 U.S.C. §78cc(b), providing that a contract made in violation of any provision of the 1934 Act is voidable at the option of the deceived party."

Similar reasoning has also been applied by this Court in construing Section 26(b) of the Public Utility Holding Company Act of 1935, 15 U.S.C. §79z, which is nearly identical with Section 215 of the Advisers Act. In Goldstein v. Groesbeck supra, 142 F.2d 422 (2d Cir. 1944), this Court said, referring to Section 26 of the Holding Company Act (p. 426),

> ". . . §26 is incomplete, if not ineffective, unless it is considered to authorize recovery by the operating companies."

The Investment Company Act of 1940, 15 U.S.C. §80a-1 et seq., contains yet another nearly identical provision dealing with the validity of contracts made in violation of that Act. Section 47 of the Investment Company Act, 15 U.S.C. §80a-47, "was copied verbatim from Section 26(b) of the Public Utility Holding Company Act of 1935 . . . " Brown v. Bullock, 194 F.Supp. 207, 225 (S.D.N.Y. 1961), aff'd en banc 294 F.2d 415 (2d Cir. 1961). The Investment Company Act constituted Title I of the very bill of which the Advisers Act was Title II. As is shown below, these enactments were intended to operate similarly in certain respects. It was held in Brown v. Bullock that Section 47 of the Investment Company Act, the section dealing with the validity of contracts, supported the implication of a private right of action.

To summarize, we urge that the language and structure of the Advisers Act strongly supports the implication of a private right of action. The question remains whether there is anything in the Act or its history demonstrating that the Congress intended to withhold a private remedy. As the District Court opinion states in Brown v. Bullock, supra, 194 F.Supp. 207, 224,

> "Implied rights of action are not contingent upon statutory language which affirmatively indicates that they are intended. On the contrary, they are implied unless the legislation evidences a contrary intention."

Consideration of this question will necessitate discussion of Section 214 of the Advisers Act and its history.

D. The language of Section 214 of the Advisers Act does not militate against the finding of a private right of action; in fact, it supports such right.

The jurisdiction and venue provisions governing suits under the Advisers Act are found in Section 214 thereof, 15 U.S.C. §80b-14, which reads as follows:

> "The district courts of the United States and the United States courts of any Territory or other place subject to

the jurisdiction of the United States shall have jurisdiction of violations of this subchapter or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity to enjoin any violation of this subchapter or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enjoin any violation of this subchapter or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28, and section 7, as amended, of the Act entitled 'An Act to establish a court of appeals for the District of Columbia', approved February 9, 1893. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against the Commission in any court."

This language is similar to, but not quite the same as, the language of the jurisdictional sections of other federal securities laws. The jurisdictional provisions of the Securities Act of 1933 (15 U.S.C. §77v), the Securities Exchange Act of 1934 (15 U.S.C. §78aa), the Public Utility Holding Company Act of 1935 (15 U.S.C. §79y), and the Investment Company Act of 1940 (15 U.S.C.

§80a-43) all refer not only to suits in equity but also to "actions at law brought to enforce any liability or duty" created by these statutes.

The omission of this language from Section 214 of the Advisers Act is the principal basis for the argument by defendants-appellees that no private right of action exists under the Advisers Act. This Court has asked for comment on the reason, if any, for the difference in phraseology.

There are no specific references in the legislative history which explain the reason for the difference in language between the Advisers Act jurisdictional section and the corresponding provisions of other securities laws. The difference may be attributable to legislative oversight.

There is another possible explanation, however. The other securities laws above referred to contain provisions which _expressly_ create private rights of action under certain sections, although not under others. For example, private rights of action are expressly created under Sections 11 and 12 of the Securities Act; under Sections 9(e), 16(b) and 18 of the Securities Exchange Act; under Sections 16(a) and 17(b) of the Public

Utility Holding Company Act; and under Section 30(f) of the Investment Company Act.

Because of the existence of certain expressly created private rights of action in those statutes, the inclusion in their jurisdictional sections of references to "actions at law" is entirely understandable.

The Advisers Act contains no expressly created private rights of action. This may explain the absence from Section 214 of any references to "actions at law." The failure to include such a reference is entirely consistent with careful draftsmanship.*

This does not mean that the failure of the Congress to create express private remedies is an indication that the Congress intended to withhold them. As above noted, even in statutes wherein the Congress created express private remedies under some sections,

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*This is the precise position which was taken by the Securities and Exchange Commission in two amicus curiae briefs filed by it in 1958 in the case of Hull v. Newman, Kennedy & Company (S.D.N.Y. Civ. Act. No. 118-283). There, the Commission argued that a private right of action exists under the Advisers Act, and argued that Section 214 does not constitute any indication of a legislative intent to withhold a private right of action, using the reasoning outlined above. The Hull case was evidently settled before the Court had the opportunity to rule.

the courts have found implied private remedies under other sections. Moreover, it must be understood that the Advisers Act was not intended to create as broad and comprehensive a scheme of legislation as that created under the Exchange Act, for example.

The Advisers Act requires registration of certain investment advisers (Section 203, 15 U.S.C. §80b-3), and prohibits certain fraudulent or otherwise undesirable conduct (Section 206, 15 U.S.C. §80b-6; see Section 208, 15 U.S.C. §80b-8), but does little else to regulate the profession. As the Senate Committee on Banking and Currency stated in its report on the 1960 amendments to the Act, S. Rep. No. 1760, 86th Cong., 2d Sess., 1960 U.S. Code Cong. & Admin. News, p. 3503,

> "Of the five acts administered by the Securities and Exchange Commission, the committee is of the opinion that confronted by the problems it must solve, the Investment Advisers Act of 1940 is the most inadequate. The Investment Advisers Act of 1940 was passed as title II of the bill of which title I was the Investment Company Act. Unlike other Federal securities statutes, it has few substantive or regulatory provisions. Modeled somewhat on the broker-dealer registration provisions of the Securities Exchange Act of 1934, it resembles a continuing census of the Nation's investment advisers." (emphasis added)

For these reasons, it cannot be argued that the absence of expressly created private rights (and a jurisdictional section referring to actions at law to enforce them) indicates a Congressional intent to withhold private rights from those for whose benefit the statute was passed. Any such argument would be illogical for it would lead to the conclusion that no _implied_ rights exist unless _express_ rights are first granted. The law is otherwise. The doctrine of implied private rights of action, as above shown, arose precisely _because_ statutes obviously designed to protect certain classes of persons omitted to provide those persons with express private remedies.

Nor is there anything in those few pieces of legislative history which deal with the jurisdictional provision of the Advisers Act indicating any intent whatever on the part of the Congress to deprive investors of a private remedy thereunder.

The Investment Advisers Act, in the form in which it was originally introduced, provided that the jurisdictional provision of the Investment Company Act should be "incorporated in this title as though fully

set forth herein." S. 3580, Section 203, 76th Cong., 3d Sess. The jurisdictional section of the Investment Company Act had been copied verbatim from the Public Utility Holding Company Act. S. 3580, Section 40(a), 76th Cong., 3d Sess. The companion bill introduced in the House of Representatives at the same time contained identical jurisdictional provisions. H. R. 8935, Sections 49(a), 203, 76th Cong., 3d Sess.

The Senate bill, when it was reported out of committee, had been amended to eliminate the incorporation by reference of the jurisdictional provisions of other statutes. The jurisdictional provision in the Advisers Act was instead spelled out, and contained no reference to actions at law to enforce liabilities created by that Act. But the committee report contains no comment upon the absence of such language, and certainly contains no indication that the deletion of references to actions at law was to prevent the implication of private rights of action.

In fact, the only comment in the Senate committee report dealing with the jurisdictional provisions of the Investment Company Act and the Investment Advisers Act demonstrates that no significant difference between those provisions was intended. The report discussed the provisions

dealing with "unlawful representations, administration and enforcement machinery and formal provisions" as a group. In its discussion of such provisions as they appeared in the Advisers Act, the report stated that the Advisers Act "contains provisions generally comparable to those of" the Investment Company Act. S. Rep. 1775, 76th Cong., 3d Sess., p. 23.

The House Committee on Interstate and Foreign Commerce reported out a bill identical to the Senate bill. H. R. 10065, 76th Cong., 3d Sess. The House Committee report also states that the sections of the Advisers Act dealing with "unlawful representations, administrative and enforcement machinery" contain "provisions comparable to those in" the Investment Company Act. H. Rep. No. 2639, 76th Cong., 3d Sess., p. 30.

We respectfully urge that these references in the legislative history hardly qualify as evidence that the Congress intended to prohibit private rights of action under the Advisers Act. Not only is there no language in the committee reports which even hints at such an intention; the jurisdictional provision of the Investment Company Act, to which the jurisdictional provision of the Advisers Act was intended to be "comparable,"

has been held to support a private right of action. See Brown v. Bullock, supra.*

Section 214 also supports the implication of a private right of action by its very use of the word "violations." Section 214 gives the district courts "jurisdiction of violations of this title . . . " Similar language is found in Section 27 of the Exchange Act, 15 U.S.C. §78a. It has been held, in litigation between private parties, that "violations" refers to civil and well as criminal proceedings. See, e.g., Osborne v. Mallory, 86 F.Supp. 869 (S.D.N.Y. 1949), wherein the Court said (p. 879),

> "Section 27 of the Securities Exchange Act of 1934 .... gives a Federal district court jurisdiction over 'violations of this chapter' .... The word 'violation' is not limited to a criminal case; it includes also civil litigation."

See also Grossman v. Young, 70 F.Supp. 970 (S.D.N.Y. 1947).

For the foregoing reasons, it is respectfully urged that Section 214 of the Advisers Act, instead of negating a private right of action, actually provides such

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*The foregoing chronology and reasoning was also set forth by the Securities and Exchange Commission in its amicus curiae briefs in Hull v. Newman, Kennedy, supra, in which the Commission argued that a private right of action exists under the Advisers Act.

a right or at least supports the implication of one. In any event, Section 214 certainly does not constitute an expression of Congressional intent to prohibit private rights of action. Therefore, even if Section 214 does not specifically apply to actions by private litigants, nevertheless appellants are not deprived of their right to sue. They may rely upon the general "federal question" jurisdiction of the district courts, found in 28 U.S.C. §1331. See, Note, "Bolger v. Laventhol, Krekstein, Horwath & Horwath: Private Rights of Action Under the Investment Advisers Act," 48 Temple L. Q. 433, 447, n. 74 (1975).*

E. The authorities to date support the implication of a private right of action under the Investment Advisers Act.

In our reply brief previously filed (pp. 19-21), we have discussed the cases decided to date in which the question whether there is a private right of action under the Advisers Act was specifically considered. There is no need to reproduce that discussion in detail here. It is there shown that two district court cases have held that no private right of action exists. Gammage v. Roberts, Scott & Co., CCH Fed. Sec. L. Rep. ¶94,761 (S.D. Cal. 1974); Greenspan v. Eugene Campos Del Toro, 73-638-Civ. (S.D. Fla.,

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*They might also invoke 28 U.S.C. §1337. See Rauch v. United States Instruments, Inc., _____ F.Supp. _____, 44 L. W. 2149 (E.D. Pa., September 11, 1975).

May 17, 1974).

It is also shown in our reply brief, however, that the decisions in the Southern District of New York are to the effect that a private right of action does exist. Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F.Supp. 260 (S.D.N.Y. 1974); Jones v. Equitable Life Assurance Society, CCH Fed. Sec. L. Rep. ¶94,986 (S.D.N.Y. 1975).

The view taken in the Southern District of New York has also been adopted in the Northern District of California. Angelakis v. Churchill Management Corp., CCH Fed. Sec. L. Rep. ¶95,285 (N.D. Cal. 1975). That view has, moreover, been approved by commentators. See Lybecker, "Advisers Act Developments," 8 Review of Securities Regulations 927, 934 (April 23, 1975); Note, "Bolger v. Laventhol, Krekstein, Horwath & Horwath: Private Rights of Action Under the Investment Advisers Act," 48 Temple L. Q. 433 (1975).

It is noteworthy that the Bolger case specifically holds that Section 214 of the Advisers Act confers jurisdiction of private damage actions by its use of the word "violations."

The decision also accepts the explanation we have set forth above for the omission from Section 214 of references to actions at law to enforce liabilities.

It is also noteworthy that the SEC has recently proposed legislation which will substantially broaden the Advisers Act, and which will "clarify the existence of a private right of action based on a violation of the Act . . . " See SEC Legislative Proposals Concerning Regulation of Investment Advisers, SRLR No. 332 (December 17, 1975) pp. E-1 et seq. In its statement in support of the proposed legislation, the SEC refers to the Gammage and Greenspan cases, supra, and their reliance on the absence of a reference to "actions at law" in Section 214 of the Act to support the conclusion that no private right of action exists. The SEC's statement expresses disagreement with Greenspan, and states (p. E-7),

> "While the phrase ["actions at law"] does appear in comparable jurisdictional sections of the Securities Exchange Act of 1934 (Section 27) and the Investment Company Act of 1940 (Section 44), under which private rights of action have been held to exist, the Commission believes that the Advisers Act, properly interpreted, also affords this right. Furthermore, it is the Commission's view that it is anomalous to deny advisory clients the right to recover damages sustained as a result of a violation of the Advisers Act when private rights of action have been

implied by the courts under other federal securities laws. Moreover, private litigation would serve as a valuable adjunct to Commission enforcement action. Accordingly, in order to make it clear, to the extent that it is not already, that the private rights of action implied in other federal securities statutes also exist under the Investment Advisers Act, the Commission is of the view that the first sentence of Section 214 of the Act should be amended to conform to the first sentence of Section 44 of the Investment Company Act."

F. Summary

The proposition that there is an implied private right of action under the Investment Advisers Act is supported by the history, purpose, structure and language of the Act, as well as by the authorities interpreting it and by the history of the doctrine of implied private remedies. Those urging a contrary view can only grasp at the absence from the Act's jurisdictional provision of references to actions at law to enforce liabilities thereunder. As shown above, however, this lacuna is explainable, not significant, and certainly no indication that private rights of action were intended to be denied to those for whose benefit the statute was enacted.

POINT II

DEFENDANTS ARE SUBJECT TO THE ANTI-FRAUD PROVISIONS OF THE INVESTMENT ADVISERS ACT, AND VIOLATED THESE PROVISIONS*

Section 202(a)(11) of the Advisers Act, 15 U.S.C. §80b-2(a)(11), defines investment adviser, in pertinent part, as follows:

> "'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . . "

Some investment advisers, such as those who have a substantial number of clients and conduct an interstate business, are required to register with the Securities and Exchange Commission, under Section 203 of the Act, 15 U.S.C. §80b-3.

The anti-fraud provisions in Section 206 of the Act, 15 U.S.C. §80b-6 (quoted above, at pp. 16-17), however,

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*Although the matters which follow were presented to the District Court, they have not been previously presented to this Court. They are included here because of the Court's request for supplemental briefs on "the issues raised under the Advisers Act . . . "

apply to "any investment adviser . . ." (emphasis added), regardless of whether he is registered with the Commission. This was a result deliberately aimed at by the Congress. See 2 Loss, supra, Securities Regulation, p. 1414. See also the report of the Senate Committee on Banking and Currency on the 1960 Amendments of the Advisers Act, S. Rep. No. 1760, 86th Cong., 2d Sess., 1960 U.S. Code Cong. & Admin. News, wherein it is said (p. 3509),

> "Section 8 of the bill would amend the introductory paragraph of section 206 of the act so as to make the antifraud provisions applicable to all investment advisers whether or not registered. Section 203(b) of the act exempts from registration certain investment advisers, primarily those whose business is wholly intrastate or whose only clients are investment and insurance companies, or those who have fewer than 15 clients and do not hold themselves out generally to the public as investment advisers. While it is reasonable to exempt this group from registration, the reasons for exemption from registration do not, in the view of the committee, support a corresponding exemption from prohibitions against fraud."

Therefore, if the present defendants were investment advisers, they are subject to the provisions of Section 206, despite the fact that they were not registered.

In the case at bar, defendants Fleschner, Becker and Ehrlich were general partners of defendant Fleschner

Becker Associates, an investment partnership. Only the general partners had the power to make investment decisions for the partnership. We think it is clear that these defendants were investment advisers.* Because they exercised discretion over the management of the funds of limited partners, the activities of these defendants were functionally no different from the activities of an adviser who simply makes recommendations. Here, the adviser-defendants simply went a step further, and acted on their own recommendation, for the accounts of limited partners.

The Advisers Act itself seems to contemplate that this type of fund management is an adviser activity. Section 205 of the Act, 15 U.S.C. §80b-5, for example, which deals with adviser contracts, defines "investment advisory contract" to include any agreement whereby a person agrees "to manage any investment or trading account of another person . . . " other than a registered investment company. The Securities and Exchange Commission has also adopted the view that general or managing partners

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*The remaining defendants, we urge, are liable as aiders and abettors of the adviser-defendants. See. e.g., Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F.Supp. 260 (S.D.N.Y. 1974) ("It is now well settled that accountants who aid and abet others in violating the anti-fraud provisions of the securities laws may be held jointly liable with such persons in private actions for damages," p. 268).

of investment partnerships are within the definition of "investment adviser."

In 1969, at a program on investment partnerships sponsored by the Practicing Law Institute, Mr. Ezra Weiss, formerly chief counsel to the SEC's Division of Trading and Markets, made the following statements concerning general partners of investment partnerships:

> "As I see it, the significant factor under the Investment Advisers Act of 1940 is the creation of the limited partnership and the use of it as a vehicle for interested investors in having their funds, to the extent of their respective contributions, given expert management by the general partner who usually holds himself out, or is generally regarded, as a market expert.
>
> "From a realistic point of view, this arrangement is the equivalent of one in which the limited partner places his funds with the general partner to trade and invest in accordance with the sole discretion of the general partner.
>
> "This appears to me to be an adviser activity by the general partner, and the following is my analysis. First, under Section 202(a)(11) of the Investment Advisers Act, if a person recommends to another the investment in or sale or the purchase of a security, he comes within the definition of an 'investment adviser' if he does this for compensation.
>
> "He is an investment adviser, it seems to me, if he actually carries out on a discretionary basis the course he recommends. In other words, the act of recommending is embodied in the act of managing, and the person who entrusts his funds obviously relies upon the advice

> of the person who deals with his funds on a discretionary basis.
>
> "This view -- that the management of funds is an investor advisory function -- is fortified also by the last paragraph of Section 205 of the act, which defines the term 'investment adviser contract' as including any arrangement, and I quote, 'whereby a person agrees to act as investment adviser or to manage any investment or trading account . . . . '
>
> "If there were any further doubts on this score, I think convincing reference can be made to a recent Commission opinion in the case of Roman S. Gorski [Investment Advisers Act Release No. 214, December 22, 1967], which treats as investment advisory services the operation of client's fund on a discretionary basis."
>
> Investment Partnerships and "Offshore" Investment Funds (PLI, 1969), pp. 361-363 (emphasis added).

This persuasive analysis has been reconfirmed by the SEC staff in a recent response to a request for a "no action letter." In Rami Hofshi, 1973 CCH Fed. Sec. L. Rep. ¶79,441 (available July 20, 1973), it appeared that Mr. Hofshi was the "operations partner" of an "investment club." In this capacity he made "all of the investment decisions for the club," and received compensation therefor. The staff response stated,

> "An investment adviser is defined as any person who, for compensation, engages in the business of advising others, either directly or through publications of writings, as to the value of securities

or as to the advisability of investing in, purchasing, or selling securities or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. It appears that you would fall into this category and would be required to register as an investment adviser, unless some exemption is available." (emphasis added)

See also the Report of the SEC Advisory Committee on Investment Management Services for Individual Investors, SRLR No. 186 (January 24, 1973) pp. G-1 et seq. It is there again made clear that management of investment portfolios on a discretionary basis constitutes the giving of investment advice. For example, the report states (p. G-4),

> "Many portfolio managers, even those for large institutions, determine as of any given moment upon the same securities to be recommended to customers having the same objectives. This approach should not be discouraged since in this way each customer gets the best advice which the investment manager has to offer." (emphasis added)

The report also states, in a section discussing the exemption from the definition of "investment adviser" for certain brokerage activity (p. G-12),

> "The Committee does not believe that the exclusion in Section 202(a)(11)(C) should be available to a broker-dealer who actively solicits customers for an investment management service. However, the Committee

> recognizes that brokers have traditionally handled discretionary accounts for customers. In situations where a broker merely accepts discretionary trading authority from clients as an accommodation to clients, it would appear that the investment advice rendered in connection therewith should be deemed solely incidental to its business as a broker." (emphasis added)

Here, of course, the investment advice given by defendants was not incidental to a brokerage business and was not done merely for commissions. Rather, it was done under a special arrangement for substantial compensation, i.e., 20% of the operating profits.

Finally, the Court's attention is invited to the SEC's Institutional Investor Study, and in particular to Volume 1, wherein the following points are made (pp. vx-xvi):

> "The Study examined the activities of hedge funds. These investment vehicles generally are organized as limited partnerships having fewer than 100 partners . . . .
>
> "Often the hedge funds' managing partners have other significant advisory functions, such as the management of registered investment companies . . . .
>
> "Although hedge funds bear attributes of investment companies and their general partners perform many of the same functions as investment advisers, neither the funds nor their general partners ordinarily are registered under either the Investment Company Act or the Investment Advisers Act of 1940 . . . .

"As a result of the Study's review of hedge funds' operations, it now appears practicable to clarify the applicability to hedge funds of registration requirements under one or more of the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934, and to formulate any necessary rules regarding such funds under the appropriate laws. <u>The Commission does not believe that new legislation is required</u> and will take the steps necessary to accomplish this purpose." (emphasis added)

The observation in the <u>Institutional Investor Study</u> that neither investment partnerships nor their general partners are ordinarily registered under the Advisers Act does not mean, of course, that they are not investment advisers. It simply means that in the years under study, investment partnerships and their general partners did not understand that they had any obligation to <u>register</u>.

There are no court decisions which have considered the question squarely. It is noteworthy, however, that in <u>Bolger</u> v. <u>Laventhol, Krekstein, Horwath & Horwath</u>, 381 F.Supp. 260 (S.D.N.Y. 1974), an action brought by limited partners of an investment partnership, the general partners were assumed to be investment advisers within the meaning of the Advisers Act, and conceded as much for purposes of the motion there involved.

In view of the foregoing, we think it is plain that defendants here were "investment advisers."

* * *

The defendants here, with actual knowledge of the existence and extent of the partnership's investment in unregistered securities, concealed or failed to disclose these facts. That a substantial investment in unregistered securities may be a highly material fact in the context of an investment partnership is discussed at pages 45 through 53 of our main brief to the District Court in connection with the motions below. See, e.g., Feldberg v. O'Connell, 338 F.Supp. 744 (D. Mass. 1972); SEC v. International Chemical Development Corp., 469 F.2d 20 (10th Cir. 1972); SEC v. United International Group Inc., 474 F.2d 354 (9th Cir. 1973); Armstrong Investors S.A. v. Galanis, 1970-1971 CCH ¶99,053 (S.D.N.Y. 1971); Wandschneider v. Industrial Incomes Incorporated of North America, 1971-1972 CCH ¶93,422 (S.D.N.Y. 1972); and cf. Berman v. Thomson, 312 F.Supp. 1031 (N.D. Ill. 1970). See also, Accounting Series Release No. 113, Investment Company Act Release No. 5847, CCH Fed. Sec. L. Rep. ¶72, 135 (October 21, 1969) (stating that a "prudent limit" on the acquisition by open-end companies of restricted securities would be 10%); Investment Company Act Release No. 7220 (June 9, 1972) (referring to the "serious liquidity

questions" which may arise from acquisitions of restricted securities, and requiring disclosure in registration statements wherever a registered investment company has a policy of investing in restricted securities); Accounting Series Release No. 116, Investment Company Act Release No. 6026, CCH Fed. Sec. L. Rep. ¶72,138 (April 13, 1970) (requiring disclosures as to restricted securities to be made, not only in registration statements, but in filed reports, sales literature, and reports mailed to shareholders). It is noteworthy that in Accounting Series Release No. 113, _supra_, the Commission suggested that the failure of a registered company to identify in its financial statements any restricted securities it holds might give rise to various violations of the securities laws, including violations of Rule 10b-5.

Defendants did not seriously dispute, in the Court below, that the investment in unregistered securities was a material fact. They argued instead that at the time they disseminated the financial reports here involved there had been no cases or SEC releases specifically stating that an investment in unregistered securities is a fact which should be disclosed. In this connection, defendants argued that Section 206 of the Advisers Act requires an intent to defraud and actual fraud. They said they had no intent to defraud.

We dealt with these points at pages 16 and 28 through 37 of our reply brief in the District Court on the motions below.

We pointed out that Section 206, while it does indeed prohibit actual fraud, also prohibits conduct which "operates" as a fraud or deceit on any client. Obviously, if the Congress had intended that proof of intent to defraud and actual fraud be necessary under Section 206, the subsection prohibiting conduct which "operates as a fraud" would have been redundant. Moreover, it has been clear since the decision in SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), that actual "intent to injure" is not necessary to a finding that Section 206 of the Advisers Act has been violated (p. 192). The Court in SEC v. Capital Gains Research Bureau pointed out that any such requirement would "defeat the manifest purpose of the Investment Advisers Act of 1940" (p. 192). The Court also held that its conclusion was "not in derogation of the common law of fraud" (p. 192). The Court pointed out that greater duties and fuller disclosure are required of fiduciaries than of parties in arms-length transactions, even under the common law (p. 194).

In SEC v. Capital Gains Research Bureau, an adviser had failed to disclose to clients that it was his practice to trade for his own account on the expected

market effect of his own recommendations. At the time of the conduct involved, there was no specific case, release or rule prohibiting this. The adviser argued that the Congress had not made unlawful under Section 206 the failure to disclose material facts. The Court squarely rejected this argument, and held that "[f]ailure to disclose material facts must be deemed fraud or deceit within" the meaning of the Advisers Act (p. 200).*

Nor is it important that no case or release had specifically required disclosure of investments in unregistered securities at the time of the conduct here in issue. As persons experienced in the securities business, the present defendants "could reasonably have been expected to appreciate [the] significance" of the omitted facts. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 398 (2d Cir. 1973).

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*It is true that SEC v. Capital Gains Research Bureau was decided in the context of an injunction application by the Commission. This probably accounts for the Court's additional holding that there is no requirement of proof of "actual injury to the client" (p. 195). We see no reason, however, why the above quoted holdings would not be just as applicable in civil damage actions as they are in injunction actions. Intent to defraud, for example, is not required in any damage action under Rule 10b-5. Scienter is required, but scienter means only knowledge of the misstatement or omission; it does not mean "specific fraudulent intent." Cohen v. Franchard Corporation, 478 F.2d 115, 123 (2d Cir. 1973).

Therefore, even if this were the first case on the subject, which it is not, "the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation." Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1970). See also Opper v. Hancock Securities Corp., 250 F.Supp. 668, 676 (S.D.N.Y. 1966), aff'd. per curiam 367 F.2d 157 (2d Cir. 1966); Cf. The T. J. Hooper, 60 F.2d 737, 740 (2d Cir. 1932). Moreover, as Judge Pollack stated in SEC v. Bangor Punta Corp., 331 F.Supp. 1154, 1163 (S.D.N.Y. 1971), mod. in part on other grounds sub nom. Chris-Craft Industries v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973),

> "Any differences between accepted principles of accounting and fair disclosure in a prospectus must be resolved in favor of the disclosure requirements of the securities laws . . . "

POINT III

APPELLANTS SUFFERED RECOVERABLE DAMAGES AS A RESULT OF DEFENDANTS' VIOLATIONS OF THE INVESTMENT ADVISERS ACT

The District Court, dismissing appellants' claims under Rule 10b-5, held that appellants had suffered no damages because their interim withdrawals combined with their liquidating distributions totalled slightly in excess of the amounts they had deposited with the partnership. The Court then held that the rule of damages to be applied under Section 206 of the Investment Advisers Act is no different (315a), and dismissed the Advisers Act claim as well.

In Point I of our main brief on this appeal (pp. 14 ff.), and in Point I of our reply brief (pp. 5 ff.), we have pointed out that appellants, in 1968, were induced to enter into a new partnership agreement containing substantial modifications of material terms. We have urged that this constituted a new "purchase" of a security for purposes of Rule 10b-5. We have urged that if our analysis is correct, then appellants have suffered damages in excess of $1 million even under the "traditional" test applied by the District Court. If appellants made a new investment at the time they entered into the new partnership

agreement, then the amount of that investment was the value of the interests in the old partnership which they relinquished in return for their interests in the new partnership. On their ultimate withdrawal from the partnership, they received far less than the amount so invested.

We respectfully urge that this analysis may also be applied in determining whether appellants suffered damages recoverable under the Advisers Act. The District Court seemed to hold that recoverable damages in private actions under the Advisers Act must be "actual damages," just as in actions under Rule 10b-5 (315a). If appellants suffered damages cognizable under Rule 10b-5 resulting from a new investment in 1968 induced by misleading representations and omissions, there would seem to be no reason why such damages should not also be cognizable under the Advisers Act, if caused by acts of advisers which "operated" as a fraud or deceit upon them.

* * *

We also urge that damages are recoverable by appellants under the Advisers Act, irrespective of whether the making of the 1968 Agreement constituted a new "purchase" of securities.

The District Court applied what it called a "traditional" or "out-of-pocket" rule of damages in this case (305a). The Court, on this basis, refused to recognize appellants' loss of the value of their capital accounts at the time of defendants' breach of the duty to disclose, a value which had been built up over a number of years.

With respect, we think this approach is inappropriate in an action under the Advisers Act. The "traditional" approach may be helpful in controversies between parties to an arms-length purchase or sale transaction. But the Advisers Act imposes fiduciary duties. The "traditional" approach may be helpful in cases under Rule 10b-5, which protects the integrity of a purchase or sale of securities. But, as we have previously urged, Section 206 of the Advisers Act was intended to protect the integrity, not merely of an event such as a purchase or sale, but of a <u>relationship</u>. It is for this reason, we believe, that Section 206 prohibits <u>all</u> fraud practiced by an adviser upon his client, and not merely frauds practiced in connection with the purchase or sale of a security. The omission of any reference in Section 206 to purchases or sales of securities seems to us to be a congressional recognition of the fact that the adviser-client

relationship carries with it the potential for fraud upon the client not only at the time of purchases and sales of securities, but at other times as well.

As we have noted above, the Supreme Court has held in SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), that the Advisers Act was intended to "achieve a high standard of business ethics in the securities industry" (p. 186). The Court in Capital Gains Research Bureau expressly held that (p. 191)

> "The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' . . . "

The Court in Capital Gains Research Bureau, in deciding the boundaries of the Advisers Act, drew upon the common law affecting fiduciary relationships (p. 194):

> "Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients."

The Court went on to hold that "[f]ailure to disclose material facts must be deemed fraud or deceit" within the meaning of the Advisers Act (p. 200).

We urge that the defendants here had a duty of

full disclosure to appellants which existed throughout the duration of the relationship. The duty certainly existed, we urge, at the time of all events which were important to the relationship. These events, in our view, would include the dissemination of annual financial reports, the mailing of monthly status reports, and the solicitation of new partnership agreements (regardless of whether such agreements would constitute new purchases of securities).

Losses caused by an adviser's breach of the duty to disclose at the time of any such sensitive event should, we believe, be recoverable. Defendants may urge that there are no such losses if the amounts initially committed to the advisory relationship by the client are equal to the amounts withdrawn by him over the years. But this, we urge, is not consistent with the economic facts of the advisory relationship. In the case at bar, the relationship existed for some five years. For part of that period, the partnership earned profits, and appellants' shares were credited to their capital accounts and became, we suggest, profits they had earned and property which they owned. Since a fraud by their fiduciary deprived them of most of this property, we think a recognizable loss has certainly occurred. Perhaps another way to illustrate this is to hypothesize an

adviser-client relationship which endures for 20 years, instead of only five years. It would be difficult, we think, to argue that no loss has occurred in such a case, if an adviser's fraud in the 19th year has caused the client to lose the entire value of his capital account except for a small sum initially deposited.

Yet that would be the result under the District Court's formulation. The District Court seemed to view all increases in the value of a client's capital account as "profit." He regarded that the value of a client's capital account is not entitled to the protection of the Advisers Act, except to the extent of the initial amount deposited.

The use of this "traditional" rule of damages in actions for fraud under the Advisers Act would, in our view, emasculate the remedy in many cases. If accretions to a client's capital account over the years could be characterized as "profit," advisers would be immune from liability for fraud which has consumed "profit" only, leaving a residue equal to or greater than the sum deposited (possibly years earlier) at the outset of the relationship. Such a rule of damages would encourage advisers, relying on their cushion of immunity, to treat accounts showing a substantial accretion in a careless

manner while treating with punctilious care losing or break-even accounts.

The Act, and any remedy tailored to enforce the Act, should protect all investors, not just investors whose accounts have shown no profit, by a rule which measures losses from the time of the breach of duty. The "traditional" damages rule, which was intended only to measure losses resulting from a fraudulent purchase or sale, ought not be applied to a statute that imposes fiduciary obligations and proscribes fraudulent practices occurring at <u>any</u> time in an investment advisory relationship.

We think the value of a client's capital account is protected from loss through fraud at all times during the adviser-client relationship.

The rule we espouse is consistent with the common law of fiduciary responsibility. If a fiduciary's breach of duty causes damage to the trust estate, he is liable for the diminution in the value of the estate calculated from the time of his breach of duty. See, e.g., <u>First Trust Co. of Lincoln</u> v. <u>Carlsen</u>, 131 Neb. 325, 268 N.W. 89 (1936), wherein the Supreme Court of Nebraska said (268 N.W. at 91),

> "'If the trustee commits a breach of trust, he is chargeable with . . . any loss or depreciation in value of the trust estate resulting from the breach of trust.'"

See also Lyman v. Stevens, 123 Conn. 591, 197 A.313, 317 (1938) ("The trustee, consequently, is chargeable with any loss or depreciation of value in the trust property resulting from a breach of duty"); and see Restatement, Trusts 2d, §§ 205, 206.

It is stated in III, Scott on Trusts §205, that beneficiaries may "charge the trustee with any loss which resulted from the breach of trust," and that they may charge him with "any profit which would have accrued if there had been no breach of trust" (p. 1665). And the following is stated in Bogert on Trusts §862:

> "In suits to collect money from a trustee for breach of trust, the direct damages will usually be measured by the difference between the value of the cestui's rights to principal and income before and after the breach, but consequential damages will also be awarded when they result, and exemplary damages may occasionally be given."

See also In Re Estate of Campbell, 190 Neb. 456, 209 N.W.2d 165 (1973), wherein trustees who breached their trust by failing to liquidate securities were charged with the difference between the value of the securities at the time of the breach of duty and the lower value at which the securities were eventually sold.

As the foregoing authorities demonstrate, fiduciaries who commit fraud or breach their trust may not rely upon any

"out-of-pocket" rule to shield them from liability. They are liable for any loss which results from their breach of duty, including decreases in value measured from the time of the breach.

The rule applied by the District Court in this case is based on a comparison between the amounts initially deposited and the amounts ultimately withdrawn, and thus assumes that no harm can be done by advisers to their clients except at the beginning or end of the relationship. It assumes that no harm can be done except in connection with the deposit or withdrawal of the client's funds. We have seen that this assumption is incorrect. The adviser has the power, because of the nature of the relationship, to commit breaches of fiduciary duty in ways which injure the value of the property the client has entrusted to him, even where no deposit or withdrawal is involved. The Congress recognized this potential for harm when it refused to limit the adviser's duty of disclosure to the time of purchases or sales of securities, or indeed to any other time, and instead made the duty co-extensive with the relationship.

Since the Advisers Act seems to recognize the fiduciary character of the adviser's duties, and since

it is intended to prohibit frauds committed at any time during the relationship, we think it was intended to prohibit conduct of the very sort involved in this case. We think it was also intended to prevent the very sort of harm which appellants suffered in this case, for it seems to contemplate and protect against injuries far broader than the injuries contemplated by Rule 10b-5.

Damages, we urge, are therefore recoverable. As the Court said in J. I. Case Co. v. Borak, 377 U.S. 426, 433 (1964),

> ". . . it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."

CONCLUSION

The Investment Advisers Act of 1940 has been called the "most inadequate" of the securities laws. S. Rep. No. 1760, 86th Cong., 2d Sess., 1960 U.S. Code Cong. & Admin. News, p. 3503. It has rarely been used for public or private enforcement purposes, and there are few judicial decisions under it. As a result, many activities of money managers, unreachable under Rule 10b-5 because they do not directly involve the purchase or sale of a security by investors, have gone largely unregulated.

The implication of a private right of action under the Advisers Act will do much to put teeth into the Act, and will certainly further its purpose by increasing "compliance potential"; i.e., the threat of private enforcement will have an additional deterrent effect on potential violators. See Note, "Bolger v. Laventhol, Krekstein, Horwath & Horwath: Private Rights of Action under the Investment Advisers Act," 48 Temple L.Q. 433, 434 (1975). See also J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("Private enforcement . . . provides a necessary supplement to Commission action"). The Congressional intent to protect investors, avoid frauds,

safeguard fiduciary relationships and "achieve a high standard of business ethics" will thus be carried out. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

For the reasons above stated, we respectfully urge that the history, purpose, structure and language of the Advisers Act support the implication of a private right of action thereunder. We urge that defendants-appellees are subject to the Act and that they violated it or aided and abetted its violation. We urge that plaintiffs-appellants thereby suffered damage, for which they should recover.

For the foregoing reasons, and for the reasons stated in our previously filed briefs, the judgment of the Court below should be reversed.

Respectfully submitted,

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STATE OF NEW YORK)
: SS.:
COUNTY OF NEW YORK)

CAROLE P. BROCK, being duly sworn, deposes and says: that deponent is in the employ of Shea Gould Climenko & Casey Kramer / attorneys for appellants herein, is over 18 years of age, is not a party to this action, and resides at 39-20 Greenpoint Avenue, LIC, NY 11104.

On the 30th day of January, 1976, deponent served two copies of the within Supplemental Brief for Appellants on each of the following at the addresses designated by them for that purpose:

Sullivan & Cromwell Attorneys for Appellees Fleschner, Becker and Fleschner Becker Associates 48 Wall Street New York, New York	D'Amato Costello & Shea Attorneys for Appellee Harry Goodkin & Company 116 John Street New York, New York 10038
Hill, Betts & Nash Attorneys for Appellee Ehrlich One World Trade Center Suite 5215 New York, New York	Securities and Exchange Commission Amicus Curiae 500 N. Capital Street Washington, D.C. 20549

by depositing a true and correct copy of the same, properly enclosed in a postpaid wrapper in the official depository maintained and exclusively controlled by the United States Government at 330 Madison Avenue, New York, New York 10017.

Carole P. Brock

CAROLE P. BROCK

Sworn to before me this
30th day of January, 1976

Alice Mann

Notary Public, State of New York
New York County
Expires March 30, 1976